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ACHIEVING A NATIONAL PURPOSE: *Putting Equalization Back on Track*

EXECUTIVE SUMMARY

Expert Panel on Equalization and Territorial Formula Financing

May 2006



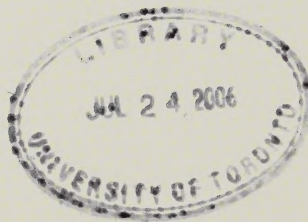
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May 2006

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance
House of Commons
Ottawa, Ontario

Dear Minister,

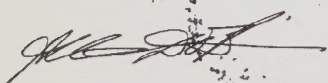
Members of the Expert Panel on Equalization and Territorial Formula Financing have spent the past year reviewing a host of issues related to Canada's Equalization program, listening to the views of provinces, experts and interested Canadians, and exploring alternative approaches.

We are pleased to provide our Panel's final report and recommendations.

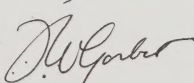
We would like to thank all those who participated in this important review process. While there are widely divergent views on how specific components of the Equalization program should be addressed, with few exceptions, we heard strong support for the program. Most want to see the Equalization program fixed, not abandoned.

We hope that this report will add to Canadians' understanding of the purpose of Equalization and the objectives it is intended to achieve. We hope it will provide a strong foundation for open, informed and constructive discussions among the provinces, the federal government and interested Canadians. Most importantly, we hope our recommendations will help put Equalization back on track and secure a solid foundation for one of Canada's essential cornerstones.

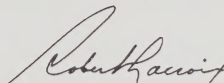
Yours sincerely,



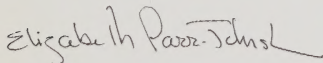
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Members of the Secretariat to the Expert Panel

- Renée St-Jacques Secretary to the Panel (March – October 2005)
- Kathleen LeClair Assistant Secretary to the Panel (June 2005 –)
- Guillaume Bissonnette Coordinator, Research and Analysis (March 2005 – January 2006)
- Frank Vermaeten Coordinator, Research and Analysis (January 2006 –)
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The Panel would also like to thank the organizations and individuals involved in planning roundtable discussions and providing expert advice. We would also like to thank representatives of provincial, territorial and federal governments, particularly finance officials who provided excellent input and advice to assist the Panel in its work.



Achieving a national purpose

Canadians have long been committed to the principle that, as part of a vast and diverse federation, people across the country should have access to reasonably comparable public services, and they should pay for those services with reasonably comparable tax levels.

In practical terms, it means that if people live in Newfoundland and Labrador or British Columbia, Montréal or Medicine Hat, their children should have reasonably similar opportunities to get a good education. They should have access to reasonably comparable health care, social services, and justice systems. And people in one part of the country shouldn't pay substantially higher taxes to support those services compared with their fellow Canadians in other parts of the country.

This important national purpose is at the heart of Canada's federation. It is enshrined in Canada's Constitution and it provides the basis for the federal government program called Equalization. Under the Equalization program, the federal government provides financial support to provinces that are less wealthy and less able than other provinces to provide public services without charging unacceptably high levels of taxes.

Equalization reflects a distinctly Canadian commitment to fairness. It has been described as the glue that holds our federation together.

In many ways, Equalization reflects a distinctly Canadian commitment to fairness. It has been described as the glue that holds our federation together.

In recent years, however, questions have been raised about whether the glue is as strong as it was in the past, whether it's being spread too thinly or too thickly in some provinces, and whether the Equalization program is, in fact, achieving the national purpose it was intended to fulfill.

On top of those questions, it's fair to say that the program may be simple in theory and principle, but that's where the simplicity ends. The saying 'the devil is in the details' certainly rings true for Equalization. In spite of the fact that the federal government will spend well over \$11 billion on Equalization in 2006–07, Equalization has been largely ignored by the vast majority of Canadians and it is understood by only a select few academics, experts, and finance officials across the country.

Questions about Equalization demand answers. They demand a thorough review of Canada's Equalization program—how it is designed and implemented and how it might be improved. Furthermore, Canadians deserve to know that their tax dollars are being used effectively to achieve an essential national purpose.

EXECUTIVE SUMMARY

In March 2005, the Expert Panel was established by the federal Minister of Finance to address key questions about the future of Canada's Equalization program. Based on extensive consultations with provinces, experts, and academics, reviews of a wide range of options and ideas, and a thorough technical analysis, the Panel has prepared a comprehensive package of recommendations designed to put Equalization back on track.

Assessing Equalization

Starting with the basics

Canada's Equalization program has been in place since the mid 1950s. While many changes have been made throughout the program's history, the basic approach involves assessing the fiscal capacity of provinces to deliver public services. Those provinces that have less ability to pay for reasonably comparable levels of public services receive Equalization payments, while others with a higher fiscal capacity do not.

Canada's approach to Equalization may be unique, but it's important to understand that most countries with a combination of federal and regional governments provide some form of redistribution of funding to ensure that common objectives are met.

Getting the facts right

The federal government pays for Equalization through general taxes paid by all Canadian taxpayers.

While some have talked about money being transferred from one province to another, in fact, all the money for Equalization comes from Canadian taxpayers across the country and is shared among the less wealthy provinces. Equalization is paid by the federal government to provincial governments and does not include any sharing of provincial revenues among provincial governments.

There are no strings attached to Equalization funding.

The federal government doesn't tell provinces how to spend Equalization funding – there are no conditions placed on how funds should be used or what, if any, standards should be achieved. Provinces make decisions on behalf of their residents and they are accountable to their electors for the services they provide.

Equalization has largely been ignored by the vast majority of Canadians and it is understood by only a select few academics, experts, and finance officials across the country.

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Most people the Panel heard from want to see the Equalization program improved, not abandoned.

Equalization is designed to be a permanent program.

Unlike most other federal government programs, Equalization is enshrined in Canada's Constitution. How the program is designed and how much money it involves can be and is changed on a periodic basis. But without a change in Canada's Constitution, the program will remain an essential component of Canada's federation. As long as the program is designed to bring the fiscal capacity of less wealthy provinces up to a certain standard, unless all provinces have the same fiscal capacity, some will receive Equalization payments and some won't.

Equalization doesn't level the playing field among all provinces.

Equalization brings less wealthy provinces up to a common standard, but it doesn't bring wealthier provinces like Alberta and Ontario down to the standard.

Resource revenues in one province are not shared with other provinces.

Provinces keep all the money they raise from resources and all their other tax bases. No provincial government funds go to support Equalization. Although some provinces talk about having their resource revenues "clawed-back," the only impact from Equalization is that provinces get less Equalization funding if their own revenues increase. That's the way Equalization is supposed to work.

Equalization is designed to address fiscal disparities among provinces.

Provincial premiers have raised concerns about a fiscal imbalance between provincial and federal governments. The issue relates to whether or not the responsibilities of provinces and the federal government are matched with their respective abilities to pay. While Equalization does provide financial support from the federal government to receiving provinces, it is not designed or intended to address the broader issue of fiscal imbalance between the provinces and the federal government.

Identifying the key issues

As a result of its consultations and discussions, the Panel learned that:

- ***Most want to see the Equalization program improved, not abandoned.***

While fundamental questions have been raised about the purpose and effectiveness of Equalization, most believe that Equalization meets an important national purpose and it is an essential component of Canada's

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intergovernmental fiscal arrangements. Furthermore, information reviewed by the Panel and included in this report suggests that Equalization has been effective in reducing the financial gap between wealthy and less wealthy provinces. For provinces that receive Equalization payments, it's an important source of funds that helps them to achieve the objective of providing reasonably comparable public services at reasonably comparable levels of taxation.

- ***Equalization should be put back on track through a principle-based, formula-driven approach.***

The Panel consistently heard concerns about what many saw as an increasingly ad hoc approach to Equalization. Before 2004, Equalization was based on a formula that determined both the overall amount of money to be provided for Equalization and the allocation to individual provinces. The formula was complex and was not without its share of problems. However, the New Framework introduced by the federal government in 2004 has been consistently criticized by provinces and academics. On top of that, many questioned the impact of separate Offshore Accords with Newfoundland and Labrador and Nova Scotia on the Equalization program. The result is a call to put Equalization back on track and return to a new, less complex, formula.

- ***The treatment of resource revenues is the most complex and controversial aspect of Equalization.***

Different provinces, experts, and analysts have different ideas as to how the Equalization program can and should be improved. By far, the most contentious issue involves how resource revenues should be treated in the formula. The Panel heard strongly held and diametrically opposing views ranging from excluding resource revenues entirely to including them completely. Given the importance of resources to the economies of some provinces and the impact of high prices for oil and gas in particular, this issue has direct bearing not only on the Equalization program but on the potential for resource revenues to increase disparities among provinces.

If there was one consistent message the Panel heard, it was a call to return to a principle-based formula-driven approach.

The Panel's goal was to put Equalization back on track – to develop a sound and effective program and establish a firm and sustainable foundation for the future.

Putting Equalization back on track

There is no perfect solution for Equalization in Canada. Given the dynamics and diversity of Canada's federation, perfection will undoubtedly continue to elude all of us.

Nonetheless, the Panel's goal was to put Equalization back on track—to develop a sound and effective program and establish a firm and sustainable foundation for the future.

The starting point is a clear set of principles, and the result is a balanced package of recommendations addressing a wide range of options and ideas. The key question for the Panel was: *Will this result in a better Equalization program for all Canadians?* In the Panel's view, the answer is yes.

The Panel's Recommendations

Starting with principles

1. *A clear set of principles should be adopted to guide future development of the Equalization program in Canada.*

Returning to a rules-based, formula-driven approach

2. *A renewed Equalization formula should be developed and used to determine both the size of the Equalization pool and the allocation to individual provinces.*
3. *A 10-province standard should be adopted.*
4. *Equalization should continue to focus on fiscal capacity rather than assessing expenditure needs in individual provinces.*
5. *Equalization should be the primary vehicle for equalizing fiscal capacity among provinces.*

Improving the Equalization formula

6. *The Representative Tax System (RTS) approach for assessing fiscal capacity of provinces should be retained.*
7. *Steps should be taken to simplify the Representative Tax System (RTS).*
8. *A new measure for residential property taxes should be implemented based on market value assessment for residential property.*
9. *User fees should not be included in Equalization.*

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Striking a balance on the treatment of resource revenues

- 10. In principle, natural resource revenues should provide a net fiscal benefit to provinces that own them.*
- 11. Fifty percent of provincial resource revenues should be included in determining the overall size of the Equalization pool.*
- 12. Actual resource revenues should be used as the measure of fiscal capacity in the Equalization formula.*
- 13. All resource revenues should be treated in the same way.*
- 14. A cap should be implemented to ensure that, as a result of Equalization, no receiving province ends up with a fiscal capacity higher than that of the lowest non-receiving province.*

Improving predictability and stability

- 15. The current approach for determining Equalization entitlements and payments should be replaced with a one estimate, one entitlement, one payment approach.*
- 16. Three-year moving averages combined with the use of two-year lagged data should be used to smooth out the impact of year-over-year changes.*

Assessing Equalization

- 17. The federal government should track and report publicly on measures of fiscal disparities across provinces.*

Improving governance and transparency

- 18. A more rigorous process should be put in place to improve transparency, communications, and governance. This is preferable to setting up a permanent independent commission to oversee Equalization.*

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The Panel's recommendations result in similar fiscal capacities for all receiving provinces after Equalization.

Assessing the impact

The Panel understands that the best ideas can sound good in principle, but what people really want to know is: What's the bottom line? Will the Panel's recommendations have an impact on whether or not a province qualifies for Equalization, how much it would receive, and how that compares with what it currently receives?

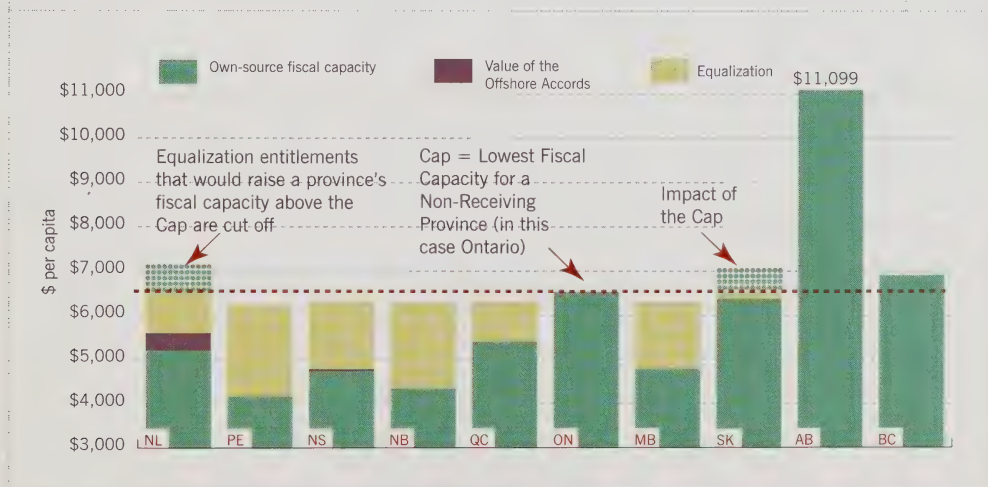
The Panel has done a thorough technical analysis to provide a snapshot of the combined financial impact of its recommendations. It's important to keep in mind that it's just that, a snapshot. Actual numbers and allocations can and will vary depending on circumstances at the time.

The Panel's projections show what the allocation to the various provinces would be in 2007–08, the first year that our recommendations could be implemented. Two comparisons are shown: one with the amounts announced for 2006–07 by the federal Minister of Finance in November 2005, and one with a base case that reflects a formula-driven approach similar to what was in place before 2004.

The analysis shows that:

- Consistent with the purpose of Equalization, the Panel's recommendations result in similar fiscal capacities among all receiving provinces after Equalization.

Provincial Fiscal Capacity Before and After Equalization (using the Panel's formula) for 2007–08



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- The total cost of the Equalization program proposed by the Panel is more than the current program. That's primarily because of the move to a 10-province standard and because the latest data reflect higher oil and gas prices.
- In the Panel's view, using a formula-to-formula comparison gives the most accurate picture of the potential impact of their recommendations. In this case, because of its higher fiscal capacity, British Columbia would not be eligible for Equalization under the Panel's recommended formula and would be entitled to only a small amount of funding under the previous formula. Newfoundland and Labrador would receive less under the Panel's approach, primarily because of the Panel's recommendation that no receiving province should have a higher fiscal capacity after Equalization than the lowest non-receiving province. This cap affects Newfoundland and Labrador's entitlement to Equalization because its fiscal capacity is greater than Ontario's.
- If you compare each province's allocation under the Panel's recommendations to the amounts announced under the New Framework in 2006–07, two receiving provinces receive less while the others receive more. This is primarily because of the return to a formula-driven approach which puts all provinces on a similar footing.

Provincial Fiscal Capacity Before and After Equalization for 2007–08 ¹										
	\$ per capita									
	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Fiscal Capacity (using the Panel's formula)										
Before Equalization	5,601	4,167	4,784	4,346	5,406	6,534	4,785	6,377	11,099	6,913
Equalization	933	2,079	1,560	1,945	917	0	1,528	157	0	0
After Equalization	6,534	6,246	6,344	6,291	6,322	6,534	6,313	6,534	11,099	6,913

¹ Table shows the before Equalization fiscal capacity of provinces using a 100 percent inclusion rate for resource revenues and includes payments provided through the Offshore Accords. Equalization entitlements are shown net of the fiscal capacity cap.

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Formula-to-Formula Comparison for 2007–08											
	\$ million / \$ per capita										
	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	TOTAL
Panel's Recommendations											
Total Entitlements	482	286	1,462	1,462	6,926	0	1,789	156	0	0	12,563
Per Capita Entitlements	933	2,079	1,560	1,945	917	0	1,528	157	0	0	
Base Case Scenario											
Total Entitlements	587	282	1,363	1,417	6,273	0	1,720	0	0	35	11,676
Per Capita Entitlements	1,136	2,047	1,454	1,885	830	0	1,468	0	0	8	
Changes											
Total Entitlements	-105	4	99	45	653	0	69	156	0	-35	887
Per Capita Entitlements	-203	31	105	60	86	0	59	157	0	-8	

Note: Totals may not add due to rounding.

Benefits of the Panel's recommendations

- Equalization is returned to a principle-based, formula-driven approach with a solid foundation for the future.
- Moving to a 10-province standard is a principled approach that reflects the true nature of Canada's federation and the real diversity among the provinces.
- Although Equalization will never be a simple program, the Panel's recommendations result in a considerably simpler and more transparent approach and should make the basics of Equalization more easily understood by Canadians.
- While the approach is not as certain as the New Framework, particularly for the federal government, the use of moving averages provides greater stability and at the same time accommodates the wishes of the provinces to return to a formula-driven approach.

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- Taken together, the package of recommendations provides a balanced approach that carefully weighs the pros and cons of different options and combines them into a solid Equalization formula for the future.
- Instead of an all-or-nothing approach to the treatment of resource revenues, the Panel's recommendations balance the various options and provide a reasonable solution, a workable solution that provides the best outcomes in terms of its overall impact on provinces.
- The Panel's recommendations for a rigorous review and reporting process should result in a more open and transparent Equalization program.

Concluding comments

The Panel appreciates very much the extensive cooperation, ideas, and insight provided by the provinces and by leading experts and academics across Canada.

Throughout the process, we were struck by how little is known about Canada's Equalization program and the many misconceptions about what it is and is not designed to achieve. We also listened carefully over the past few months while the purpose of Equalization was questioned and serious concerns were raised about its future viability in Canada.

As Panel members, we hope our report will shed more light on this important Canadian program. And we hope our recommendations will help focus the debate and achieve the objective of putting Equalization back on track.

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